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No. _____

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a state tax imposed on income received by shareholders of mutual funds derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 (1988).

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
OPINIONS BELOW	1
JURISDICTION	2
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	2
REASONS FOR GRANTING THE WRIT	7
I. THERE IS A CONFLICT AMONG STATE COURTS OF LAST RESORT AS TO WHETHER STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS VIOLATES 31 U.S.C. § 3124	7
II. THE DECISION OF THE NEBRASKA SUPREME COURT THAT 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS IS CONTRARY TO DECISIONS OF THIS COURT INTERPRETING § 3124	10
III. WHETHER 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE DECIDED BY THIS COURT	16
CONCLUSION	18
APPENDICES	A-1

TABLE OF AUTHORITIES

	Page
CASES CITED:	
American Bank and Trust Co. v. Dallas County, 463 U.S. 855 (1983)	11, 12, 13
Andras v. Department of Revenue, 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E.2d 439 (1987), cert. denied, 485 U.S. 960 (1988)	8, 9
Borg v. Dept. of Revenue, 308 Or. 34, 774 P.2d 1099 (1989)	8, 16
Capital Preservation v. Revenue Dept., 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. Ct. App. 1988)	8
Comptroller v. First United Bank, 320 Md. 352, 578 A.2d 192 (1990)	8, 9
Department of Revenue v. Page, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989)	8, 9
Everett v. Dept. of Revenue and Finance, 470 N.W.2d 13 (Iowa 1991)	8, 9
Federal Land Bank v. Bd. of Cty. Comm'rs, 363 U.S. 146 (1961)	16
First Nat'l Bank of Atlanta v. Bartow Cty. Assrs., 470 U.S. 583 (1985)	14
Hammond Lead Products v. Tax Com'rs, 575 N.E.2d 998 (Ind. 1991)	8, 9
In re Thomas Sawyer Estate, 149 Vt. 541, 546 A.2d 784 (1987)	8
Loewenstein v. State, 244 Neb. 82, 504 N.W.2d 800 (1993)	1, 3, 5, 6, 12, 15
Massman Const. v. Director of Revenue, 765 S.W.2d 592 (Mo. 1989)	8

TABLE OF AUTHORITIES – Continued

Page

Matz v. Department of Treasury, 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986) 8

Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983) 11

Offutt Housing Co. v. County of Sarpy, 351 U.S. 253 (1956) 17

Rockford Life Ins. Co. v. Illinois Dep't. of Revenue, 482 U.S. 182 (1987) 13, 15

Smith v. Davis, 323 U.S. 111 (1944) 14

Union Planters Nat'l Bank v. United States, 426 F.2d 115 (6th Cir.), cert. denied, 400 U.S. 827 (1970) 9

STATUTES CITED:

Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067 11

Neb. Rev. Stat. § 77-2715(2) (1990) 3

Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1992) ... 4, 5

28 U.S.C. § 1257(a) 2

31 U.S.C. § 3124 (1988) ..... *passim*

Rev. Stat. § 3701, as amended, 31 U.S.C. § 724 (1976) 10, 11, 2

OTHER CITATIONS:

U.S. Const. art. VI, cl. 2 2

Revenue Ruling 22-85-1 ..... 4, 5, 6

Revenue Ruling 22-87-4 5

Tribe, American Constitutional Law, 514-18 (2d ed. 1988) 16

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OPINIONS BELOW

The opinion of the Supreme Court of Nebraska (App. A, ***infra***) is reported as ***Loewenstein v. State,*** 244 Neb. 82, 504 N.W.2d 800 (1993). The opinion of the District Court of Lancaster County, Nebraska (App. B, ***infra***), and the Order amending the district court's opinion (App. C, ***infra***), are not reported.

JURISDICTION

The opinion and judgment of the Supreme Court of Nebraska was entered on August 27, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

The Supremacy Clause of the United States Constitution, Article VI, clause 2, provides, in pertinent part:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . , shall be the supreme Law of the Land. . . .

STATEMENT OF THE CASE

The controversy in this case arose as a result of the State of Nebraska's taxation of income received by Respondent John Loewenstein from investments in mutual funds. Loewenstein, a Nebraska resident, owned shares in two mutual funds, the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury

Obligations [the "Trusts"]. The Trusts are no-load, diversified investment companies whose primary objective is to receive current income from ownership of U.S. government obligations. The Trusts invest only in U.S. government obligations and distribute all of their income each year to their shareholders.

The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly called "repos". A standard repurchase agreement consists of a two-part transaction. In step one a party who holds federal obligations and who is seeking cash (the seller-borrower) sells the government obligations to a party who has available cash and who is seeking federal obligations for an investment or some other trading purpose, the buyer-lender (in this case, the Trusts). At the time the contract is formed the buyer-lender agrees to sell back to the seller-borrower, and the seller-borrower agrees to repurchase, the obligations at a higher price than at step one. The resale price includes interest for the period of the sale. The interest paid to the buyer is generally less than that earned by the federal securities; this difference is the seller-borrower's margin of profit. 244 Neb. at 85-86, 504 N.W.2d at 802. The income distributed to Loewenstein by the Trusts flowed both from the Trusts' direct investment in federal securities and from the Trusts' participation in repurchase agreements.

Nebraska imposes a tax on an individual's "federal adjusted gross income", with certain modifications. Neb. Rev. Stat. § 77-2715(2) (1990). One such modification is an adjustment reducing income subject to taxation for "interest or dividends received by the owner of obligations of

the United States . . . but exempt from state income taxes under the laws of the United States; . . . . " Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1992). In 1985, the Nebraska Department of Revenue issued a Revenue Ruling determining that income received from repurchase agreements involving federal obligations was subject to Nebraska income tax.[1] Based on the Department's Revenue Ruling,

[1] Revenue Ruling 22-85-1 provides, in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.
>
> The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

Loewenstein was required to pay Nebraska income taxes on the interest income he received from the Trusts attributable to the Trusts' participation in repurchase agreements involving federal securities.

Loewenstein instituted a declaratory judgment action in the District Court of Lancaster County, Nebraska, asking that another Revenue Ruling relating to the taxation of income from the Trusts issued by the Department (Revenue Ruling 22-87-4) be declared invalid as contrary to 31 U.S.C. § 3124 and the Supremacy Clause of the United States Constitution. (App. D, ***infra***). Subsequently, the parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. (App. F, ***infra***). The district court found that both rulings violated § 3124 and the Supremacy Clause, and, therefore, declared them void. (App. B and App. C, ***infra***). The State appealed the district court's decision declaring invalid Revenue Ruling 22-85-1.[2]

On appeal, a majority of the Supreme Court of Nebraska affirmed the district court's finding that Revenue Ruling 22-85-1 was invalid. The majority recognized that most courts which have considered the issue have determined that income attributable to repurchase transactions involving federal securities is not exempt from state taxation under § 3124. 244 Neb. at 89-90. 504 N.W.2d at 804-05. It declined, however, to follow this line of

[2] The State did not appeal the district court's decision finding Revenue Ruling 22-87-4 invalid. The substance of the ruling was effectively repealed by the enactment of 1991 Neb. Laws, LB 773, § 13 (***codified at*** Neb. Rev. Stat. § 77-2716 (Cum. Supp. 1992)).

authority, stating "[t]he rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities." *Id.* at 90, 504 N.W.2d at 805. Stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124 . . . ", the majority concluded that "the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the market for federal securities." *Id.* The majority thus found "that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124." *Id.* at 91, 504 N.W.2d at 805.

In a dissenting opinion, Justice Caporale, joined by Justice Grant, expressed disagreement with the majority's opinion, stating:

> [W]hen stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

Id. at 91, 504 N.W.2d at 805 (Caporale, J., dissenting).

REASONS FOR GRANTING THE WRIT

The decision of the Supreme Court of Nebraska presents a question of importance regarding the power of the states to tax income derived from repurchase agreements involving federal securities. The question of whether state taxation of such income violates 31 U.S.C. § 3124 is one which has been addressed by several state courts, a clear majority of which have held that state taxation of income from repurchase agreements involving federal government obligations is not barred by § 3124. The Nebraska Supreme Court's conclusion that income received by Loewenstein from repurchase transactions involving federal securities is exempt from state taxation under § 3124 is not only in conflict with decisions of several other state courts, but also is contrary to decisions of this Court interpreting the scope of the exemption from state taxation provided to U.S. government obligations under § 3124. The question of whether § 3124 precludes state taxation of income from repurchase agreements involving federal obligations presents an important question of federal law which should be decided by this Court.

I. THERE IS A CONFLICT AMONG STATE COURTS OF LAST RESORT AS TO WHETHER STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS VIOLATES 31 U.S.C. § 3124.

The Supreme Court of Nebraska's holding that income received by a shareholder of a mutual fund derived from repurchase agreements involving federal

securities is exempt from state taxation under § 3124 is in conflict with every decision of the highest courts of states which have considered the issue of the taxability of income from repurchase agreements. The highest courts of six states have held that income derived from repurchase agreements is not exempt from state taxation under § 3124.[3] In addition, three other state appellate courts have upheld the state's power to tax such income.[4] The only decision in agreement with the Supreme Court of Nebraska was rendered by an intermediate state appellate court.[5] As a state court of last resort, the Supreme Court of Nebraska stands alone in its view that income from repurchase agreements involving federal obligations is exempt from state taxation under § 3124.

Courts upholding the taxation of income from repurchase agreements have properly recognized that repos, despite their name, are actually secured loans, and that the investor, at least for tax purposes, never owns the federal securities. ***Everett v. Department of Revenue and***

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[3] ***Hammond Lead Products v. Tax Com'rs,*** 575 N.E.2d 998 (Ind. 1991); ***Everett v. Dept. of Revenue and Finance,*** 470 N.W.2d 13 (Iowa 1991); ***Comptroller v. First United Bank,*** 320 Md. 352, 578 A.2d 192 (1990); ***Borg v. Dept. of Revenue,*** 308 Or. 34, 774 P.2d 1099 (1989); ***Massman Const. v. Director of Revenue,*** 765 S.W.2d 592 (Mo. 1989); ***In re Thomas Sawyer Estate,*** 149 Vt. 541, 546 A.2d 784 (1987).

[4] ***Department of Revenue v. Page,*** 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989); ***Capital Preservation v. Revenue Dept.,*** 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. Ct. App. 1988); ***Andras v. Department of Revenue,*** 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E.2d 439 (1987), ***cert. denied,*** 485 U.S. 960 (1988).

[5] ***Matz v. Department of Treasury,*** 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986).

Taxation, 470 N.W.2d at 15; ***Hammond Lead Products v. Tax Com'rs,*** 575 N.E.2d at 1000; ***Department of Revenue v. Page,*** 541 So. 2d at 1275; ***Andras v. Department of Revenue,*** 154 Ill. App. 3d at ___, 106 Ill. Dec. at ___, 506 N.E.2d at 443-44. The test applied in determining the taxability of income from repurchase agreements should focus on the economic substance of the transaction, not the form or subjective intent of the parties to the agreement. ***Comptroller v. First United Bank,*** 320 Md. at ___, 578 A.2d at 201. ***See Union Planters Nat'l Bank v. United States,*** 426 F.2d 115, 118 (6th Cir.), ***cert. denied,*** 400 U.S. 827 (1970) (holding interest on municipal bonds subject to repurchase agreements not deductible for federal income tax purposes, as "tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes. . . . "). The distribution of mutual fund income derived from repos is "not interest on the federal obligation but on the repo agreements; . . . ", and is "paid not by the federal government, but by the seller-repurchasers, ... " ***Everett v. Department of Revenue and Finance,*** 470 N.W.2d at 15. As stated by the Iowa Supreme Court:

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. . . . [N]either the

> supremacy clause nor 31 U.S.C. section 3124 prevents the State from taxing the income derived from the repurchase agreements.

Id. (citations omitted).

The decision of the Supreme Court of Nebraska is at odds with numerous decisions of the highest courts of several states, as well as several intermediate state appellate courts. This conflict warrants this Court's review.

II. THE DECISION OF THE NEBRASKA SUPREME COURT THAT 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS IS CONTRARY TO DECISIONS OF THIS COURT INTERPRETING § 3124.

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

Section 3124 is a revision and recodification of Rev. Stat. § 3701, as amended, 31 U.S.C. § 724 (1976). Section 3701, as amended, provided, in part:

> [A]ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both,

> be considered, directly or indirectly, in the computation of the tax, ...

Title 31 of the United States Code was not enacted into positive law until 1982, when it was reformulated "without substantive change." *See* Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067. Since the recodification did not substantively change the statute, decisions construing § 742 are binding authority in the construction of § 3124.

The Court has "treated [§ 742] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation]." ***Memphis Bank & Trust Co. v. Garner,*** 459 U.S. 392, 397 (1983). "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " ***First Nat'l Bank of Atlanta v. Bartow Cty. Assrs.,*** 470 U.S. 583, 593 (1985). The exemption for federal obligations provided by § 3701, as amended, has been recognized as "sweeping: with specific exceptions, it 'extends to ***every form*** of taxation that would require that either the obligations or the interest thereon, or both, ***be considered, directly or indirectly, in the computation*** of the tax' (emphasis supplied)." ***American Bank and Trust Co. v. Dallas County,*** 463 U.S. 855, 862 (1983) (***citing Memphis Bank & Trust Co. v. Garner,*** 459 U.S. at 395-96). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its ***form*** if federal obligations must be considered, either directly or indirectly, in ***computing*** the tax." ***American Bank and Trust Co. v. Dallas County,*** 463 U.S. at 862 (emphasis in original).

American Bank and Trust Co. v. Dallas County involved a Texas property tax on bank shares. The tax "was computed by use of an 'equity capital formula' which involved determining the amount of the bank's capital assets, subtracting from that figure the bank's liabilities and the assessed value of the bank's real estate, and then dividing the result by the number of shares." 463 U.S. at 862-63. The Court determined the tax took "into account, at least indirectly, the federal obligations that constitute[d] a part of the bank's assets." *Id.* at 863. The Court further stated that, "[g]iving the words of amended § 3701 their ordinary meaning, there can be no question that federal obligations were considered in computing the bank shares tax at issue here. In context, the word 'considered' means taking into account, or included in the accounting." *Id.* at 862-63 (footnote omitted). Finding that § 3701 "prohibit[ed] any form of tax that would require consideration of federal obligations in computing the tax", *id.* at 865, the Court held the bank shares tax "violated the plain language of § 3701." *Id.*

The Supreme Court of Nebraska erroneously held that the state's taxation of income received by Loewenstein through distributions resulting from the Trusts participation in repurchase agreements was invalid under this Court's decisions interpreting the scope of the immunity from state taxation accorded under § 3124 and its predecessor because, "at the very least," such income was "considered indirectly in computation of the tax." 244 Neb. at 90, 504 N.W.2d at 805. Neither interest on federal obligations, nor the obligations themselves, were considered in the computation of Nebraska's taxation of Loewenstein's income. In a repurchase transaction, the

federal obligations are not actually owned by the Trusts, but are taken as security for what is, in economic effect, a loan by the Trust to the seller-borrower/repurchaser. The "interest" received by the Trusts is not interest on obligations of the federal government, but, rather, is interest paid by the seller-repurchaser pursuant to the terms of the repurchase agreements. The "interest" received by the Trusts was paid by the seller-repurchasers, not the federal government. Contrary to the Nebraska Supreme Court's conclusion, the state tax imposed on income received by Loewenstein derived from interest received by the Trusts from repurchase transactions did not consider, directly or indirectly, U.S. Government obligations or the interest paid on such obligations. The Nebraska Supreme Court's decision is based on an erroneous application of the standard for determining tax exemption under § 3124, as articulated in *American Bank and Trust Co. v. Dallas County*.

The Nebraska Supreme Court's decision also fails to give proper consideration to the Court's decision in *Rockford Life Ins. Co. v. Illinois Dep't. of Revenue*, 482 U.S. 182 (1987). In *Rockford Life*, the Court addressed whether "Ginnie Maes" were exempt from state taxation under the federal government's constitutional immunity from taxation or under the immunity statute. The Court held that "Ginnie Maes" were not entitled to exemption on either ground, finding that these instruments did not constitute an obligation of the United States, and, therefore, were not immune from state taxation. In holding the instruments did not constitute obligations of the United States under the immunity statute, the Court noted that, while the instruments contained a pledge of the "full

faith and credit of the United States", they were "neither direct nor certain obligations of the United States . . . ," as the issuer bore "the primary obligation to make timely payments – the United States' obligation [was] secondary and contingent." *Id.* at 188.

As to the claim of constitutional immunity, the Court noted the instruments contained no "binding promise by the United States to pay specified sums at specified dates." *Id.* at 189-90 (*quoting Smith v. Davis*, 323 U.S. 111, 115 (1944)). As one of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability . . . ", the Court concluded that "[t]he lack of a fixed and certain obligation by the United States in the Ginnie Mae context ma[de] this concern far too attenuated to support constitutional immunity." *Id.* at 190 (citations and footnote omitted). Moreover, "none of the proceeds of the issuance and sale of the [Ginnie Mae] certificates [were] received by the Federal Government or used to finance any governmental function." *Id.* at 191. The Court concluded by stating as follows:

> A court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established. We do well to remember the concluding words in *Smith*, which although spoken in reference to the statute, are relevant to our role in applying the constitutional doctrine as well:
>
> > 'All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed

> > to secure credit to carry on the necessary functions of government. That intent, which is largely codified in § 3701 [now § 3124], should not be expanded or modified in any degree by the judiciary.'

Id. at 191-92 (citation omitted).

The reasoning in *Rockford Life* applies in the present case. There is no direct and certain obligation of the United States government to the Trusts under the repurchase agreements. The agreements, by their terms, specify that the Trusts will not receive the monies promised by the federal government in the securities which are the subject of the repurchase transaction. In the event of default, the Trusts may sell the obligations at their then-current market value to yet another party and obtain cash from that party. Thus, the federal government does not even stand as a guarantor in relation to the Trusts.

Moreover, as in the *Rockford Life* case, the federal government never receives the proceeds of repurchase transactions. The proceeds flow between private parties, the underlying federal obligations already having been issued at the time the repurchase transaction takes place. This fact undermines the majority's finding that immunity was warranted because "the state tax impose[d] a burden on the market for federal securities." 244 Neb. at 90, 504 N.W.2d at 805. Given the nature of repurchase transactions, it is difficult to conceive how taxation of the income derived from repos and distributed to shareholders of the Trusts imposes an impermissible burden on the borrowing power of the federal government. Absent "a significant effect on the marketability or interest costs of federal securities," . . . , attempts to "find grounds for

derivative tax immunity in every speculative marginal advantage for those who deal with the government and therefore to the government pushes the search for an economic incidence (as distinct from the legal incidence) of a tax too far." ***Borg v. Dept. of Revenue,*** 308 Or. at 40, 774 P.2d at 1102 (***citing*** Tribe, American Constitutional Law 514-18 (2d ed. 1988)).

The Court should grant the writ, as the Nebraska Supreme Court's holding that income from repurchase transactions involving federal securities is entitled to immunity from state taxation is contrary to this Court's decisions applying the constitutional doctrine of intergovernmental tax immunity or the statutory immunity under § 3124.

III. WHETHER 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE DECIDED BY THIS COURT.

The Supreme Court of Nebraska's decision that Nebraska's taxation of income distributed to shareholders of mutual funds derived from repurchase agreements involving federal securities is contrary to federal law presents a question of importance necessitating review by this Court. The Court has noted the importance of questions involving the taxing power of state and local governments in relation to the federal government and its activities in granting certiorari. ***Federal Land Bank v. Bd. of Cty. Comm'rs,*** 363 U.S. 146, 149 (1961) (certiorari granted "to determine whether the State had exacted a

tax [on property of Federal Land Bank] forbidden by the Supremacy Clause of the Constitution."); ***Offutt Housing Co. v. County of Sarpy,*** 351 U.S. 253, 256 (1956) (certiorari granted because of "serious questions of state-federal relations [raised] with respect to taxation of private housing developments on Government-owned land. . . . "). The question presented involves an important issue of federal law as to the interpretation and scope of the immunity from state taxation afforded by § 3124.

Moreover, because of the conflict between the Nebraska Supreme Court's opinion and decisions of several other state courts, the tax treatment of income distributed to shareholders of mutual funds derived from repurchase agreements will not be uniform among the states if the Court declines to grant review. In those states which have held the taxation of income from repurchase transactions is not exempt under § 3124, such income will be taxed. In Nebraska, however, such income has been exempted from taxation by the Nebraska Supreme Court's interpretation of § 3124 as mandating exemption of income distributed to mutual fund shareholders from repurchase transactions. The issue of the power of states to tax such income should, as a matter of national policy, be addressed by the Court to ensure uniformity in the tax treatment of income from repurchase agreements by the states. If the Court does not grant review and reverse the Nebraska Supreme Court's erroneous application and interpretation of § 3124, the important goal of assuring uniform application of federal law will not be achieved.

CONCLUSION

The petition for a writ of certiorari to the Supreme Court of Nebraska should be granted.

Respectfully submitted,

State of Nebraska,
Department of Revenue,
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APPENDICES

APPENDIX A

OPINION OF THE SUPREME COURT OF NEBRASKA

Case Title

John Loewenstein, Appellee,

v.

State of Nebraska, Department of Revenue,
Appellant.

Case Caption

Loewenstein v. State

Filed August 27, 1993. No. S-91-255.

Appeal from the District Court for Lancaster County:
Donald E. Endacott, Judge. Affirmed.

Don Stenberg, Attorney General, and David Edward Cygan for appellant.

Terry R. Wittler, of Cline, Williams, Wright, Johnson & Oldfather, for appellee.

LOEWENSTEIN V. STATE

NO. S-91-255 – filed August 27, 1993.

1. Administrative Law: Declaratory Judgments: Appeal and Error. The standard of review on appeal from a declaratory judgment action filed under the Administrative Procedure Act in the district court prior to July 1, 1989, is de novo.

2. Appeal and Error. When the issue in a case is a question of law, an appellate court must reach a conclusion independent from the one made by the trial court.

3. Federal Acts: Intent: Taxation. The congressional intent of 31 U.S.C. § 3124 (1988) is to prevent state taxes which diminish in the *slightest degree* the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit; also, § 3124 exempts from state taxation those federal obligations, and interest thereon, which are directly and *indirectly* considered in computation of the tax and has been interpreted as a "broad" and "sweeping" exemption. It is clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt. Therefore, the income received by a mutual fund shareholder from the fund's investment in federal securities using repurchase agreements is exempt from state taxation under § 3124.

Boslaugh, White, Caporale, Shanahan, Fahrnbruch, and Lanphier, JJ., and Grant, J., Retired.

WHITE, J.

The Department of Revenue of the State of Nebraska (Department) appeals the decision of the district court for Lancaster County that Department of Revenue Ruling 22-85-1 violates 31 U.S.C. § 3124 (1988) and the Supremacy Clause of the U.S. Constitution.

The controversy in this case arose out of the State's taxation of income the appellee, John Loewenstein, received from investments in mutual funds. The appellee, a Nebraska resident, owned shares in two mutual funds,

the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury Obligations (trusts). These trusts invested exclusively in U.S. government securities either directly or through repurchase agreements. Pursuant to Revenue Ruling 22-85-1, Loewenstein was required to pay state income taxes on the interest income he received from the repurchase agreements executed by the trusts involving federal securities. Revenue Ruling 22-85-1 provides in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of the securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.

The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan

> secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

In May 1988, Loewenstein filed a declaratory judgment action under the Administrative Procedure Act, in the district court for Lancaster County, asking that Department of Revenue Ruling 22-87-4 be declared invalid pursuant to § 3124 and that the income received by Loewenstein from the trusts be declared exempt from state taxation. See Neb. Rev. Stat. § 84-911 (Reissue 1987). Thereafter, the parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. The district court found that both rulings violate § 3124 and the Supremacy Clause of the U.S. Constitution and, therefore, declared them void. The Department appeals the district court's decision, but only with respect to Revenue Ruling 22-85-1.

The Department asserts that the district court erred in determining that the income from repurchase agreements for obligations of the United States constitutes interest or a dividend received by the owner of obligations of the United States and in concluding that Revenue Ruling 22-85-1 is violative of the Supremacy Clause of the U.S. Constitution, § 3124, and Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1988). The Department's assignments of error present the following issue: whether § 3124, which provides that federal securities are exempt from state taxation, precludes Nebraska from taxing the income received by

Loewenstein from the trusts' investment in federal securities using repurchase, or repo, agreements. We conclude that this income is exempt from state taxation under § 3124 and accordingly affirm the district court's judgment invalidating Revenue Ruling 22-85-1.

The standard of review on appeal from a declaratory judgment action filed under the Administrative Procedure Act in the district court prior to July 1, 1989, is de novo on the record. See Neb. Rev. Stat. § 84-918(2) (Cum. Supp. 1992). Since the issue in this case is a question of law, we must reach a conclusion independent from the one made by the trial court. *VanDeWalle v. Albion Nat. Bank*, 243 Neb. 496, 500 N.W.2d 566 (1993).

The facts in this case are undisputed. At trial, the parties jointly introduced into evidence two stipulations. The pertinent facts stated in the second stipulation are as follows:

> 1. The Trust[s] . . . are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.
>
> 2. The Trusts do not engage in any other business.
>
> 3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M and are established under the Investment Company Act of 1940.
>
> . . . .
>
> 5. The Trusts make U.S. Government securities accessible to investors in much

smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

. . . .

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

. . . .

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

The first stipulation included the depositions of Stewart Brown, a financial analyst and university professor, and Peter Sternlight, executive vice president of the Federal Reserve Bank of New York. These depositions were not conducted by counsel in this case, but, rather, by counsel litigating a case, Page v. Department of Revenue, State of Florida, No. CI 87-2586, in the Circuit Court of the Ninth Judicial Circuit, Orange County, Florida. The parties in Page v. Department of Revenue, State of Florida litigated the same issue that we must address in this case.

Sternlight's testimony stated that repurchase agreements involving federal securities are essential to the efficient functioning of the government securities markets. He stated that repo agreements are an important method for dealers to finance their inventories of federal securities and that primary dealers underwrite 35 to 75 percent of new federal securities. Sternlight testified that an impairment of the repo market would make it less attractive for dealers to underwrite federal securities, thus adding to Treasury interest costs. Sternlight characterized repurchase transactions as the purchase and sale of securities. However, Sternlight admitted on cross-examination that repurchase transactions are very similar to collateralized loans. In addition, he stated that the function of the Federal Reserve to make short-term adjustments in the nation's money supply would be more difficult without repurchase agreements, and that the Federal Reserve would not be authorized by law to use

repurchase agreements if they were characterized as collateralized loans.

Brown's testimony supports Revenue Ruling 22-85-1. Brown testified that the economic substance of a repurchase transaction is a secured loan. Brown also stated that the Federal Reserve could still conduct open-market operations in essentially the same way without repurchase agreements.

The Department also introduced into evidence the affidavit of Donald O. Ellingson, tax law manager in the tax policy division of the Department. In his affidavit, Ellingson provided an analysis of a typical federal securities repurchase transaction between a mutual fund and a bank, the broker-dealer, based on a repo agreement identical to the one utilized by the trusts. Ellingson concluded that the income from the repo transaction was not exempt from state taxation. His conclusion was based on the same rationale applied in Revenue Ruling 22-85-1, that is, the characterization of the transaction as a loan rather than a sale.

Before we discuss the validity of Revenue Ruling 22-85-1 and the state tax authorized therein, it is helpful to briefly describe the state and federal statutory provisions which prohibit state taxation of income earned by Nebraska residents from investments in federal securities. Under Neb. Rev. Stat. § 77-2715(2) (Cum. Supp. 1988), a taxpayer is required to pay state income tax on his or her federal adjusted gross income as modified by § 77-2716. In accordance with § 77-2716(1)(a), a taxpayer may subtract from his or her federal adjusted gross

income all interest or dividend distributions from obligations of the United States which are exempt from state income taxes under the laws of the United States. The federal law which exempts such interest distributions from state taxation is § 3124. This section provides:

> **Exemption from taxation**
>
> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax
>
> . . . .

Section 3124 is a revision and recodification of 31 U.S.C. § 742 (1976). In § 742, the last sentence from the quote above read as follows: "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, *directly or indirectly*, in the computation of the tax. . . . " (Emphasis supplied.) See Act of Sept. 22, 1959, Pub. L. No. 86-346, § 105(a), 73 Stat. 621, 622. When Congress recodified § 742 as § 3124, the words "directly or indirectly" were omitted as surplus. H.R. Rep. No. 97-651, 97th Cong., 2d Sess. 94, *reprinted in* 1982 U.S. Code Cong. & Ad. News 1895, 1988 (1982). It was the intention of Congress to reformulate § 742 without a substantive change. See Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067.

Since the recodification did not substantively change the statute, the U.S. Supreme Court's construction of § 742 is also binding authority in the construction of

§ 3124. The Court has " 'treated [§ 742] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation].' " *First National Bank v. Bartow Cty. Tax Assessors*, 470 U.S. 583, 593, 105 S. Ct. 1516, 84 L. Ed. 2d 535 (1985), quoting *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S. Ct. 692, 74 L. Ed. 2d 562 (1983). The Court has interpreted the exemption for federal securities provided in § 742 as a "sweeping" and "broad" exemption. See, *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 103 S. Ct. 3369, 77 L. Ed. 2d 1072 (1983); *Memphis Bank & Trust Co. v. Garner, supra.* This exemption is intended " 'to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit.' " *Memphis Bank & Trust Co. v. Garner*, 459 U.S. at 396, quoting *Smith v. Davis*, 323 U.S. 111, 65 S. Ct. 157, 89 L. Ed. 107 (1944). However, the Court has also stated that the tax exemption provided by § 742 is not a tax shelter. *First National Bank v. Bartow Cty. Tax Assessors, supra.*

The trusts invest in federal securities in two ways. In the first method, "direct purchase and sale," the trusts purchase federal securities without any restrictions on them, hold them for an indeterminate period of time, then either collect the interest from the federal government on those obligations when they mature or sell them at a later date prior to maturity. When the interest income from such a transaction is passed on to the shareholders of the trusts, it is exempt from state taxation under § 3124. See, *American Bank & Trust Co. v. Dallas County, supra; Memphis Bank & Trust Co. v. Garner, supra; Brown v.*

Franchise Tax Bd., 197 Cal. App. 3d 300, 242 Cal. Rptr. 810 (1987). The second method of investment used by the trusts is to purchase federal securities and simultaneously enter into a repurchase agreement, agreeing to resell the obligations back to the seller at a specified date and price. The dispute in this case involves the state's taxation of the income which the trusts' shareholders receive from these repurchase transactions.

The Department argues that the trusts' repo transactions were really collateralized loans, whereby the trusts did not *own* the federal securities, but, rather, took the U.S. obligations as *security* for a short-term loan to the seller of the securities, a broker-dealer. Therefore, the income earned by the trusts (and subsequent income distributions by the trusts to their shareholders) from a repurchase transaction constituted interest payments on a loan and not interest income from the sale of federal securities. The Department further asserts that this loan was the obligation of the second party (a private party) to the repo agreement, not the obligation of the federal government. The Department concludes that since the income received by the shareholders constituted interest payments from a private party on a loan, a state tax on such income did not involve the consideration of a U.S. obligation, or the interest thereon, in computing the tax. Thus, the subject income is not tax-exempt under § 3124.

The issue in this case is one of first impression for this court. Yet, there are a few jurisdictions which have addressed this issue and have determined that the income from a repo transaction involving federal securities is not exempt from state taxation. See, *Hammond Lead*

Products v. Tax Com'rs, 575 N.E.2d 998 (Ind. 1991); *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. App. 1989); *Capital Preservation v. Rev. Dept.*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. App. 1988); *Andras v. Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439 (1987). See, also, *Union Planters Nat. Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970) (income from repo transactions involving municipal bonds not exempt from federal taxation). These courts apply a rationale similar to that proposed by the Department. That is, in a repo transaction, the seller-repurchaser (i.e., the broker-dealer) is the party who has the rights and risks associated with ownership of the securities, and as the true owner of the securities, the seller-repurchaser is the only party in the transaction who can claim the tax exemption provided by § 3124. *Hammond Lead Products v. Tax Com'rs, supra; Department of Revenue v. Page, supra; Capital Preservation v. Rev. Dept., supra; Andras v. Department of Revenue, supra.* The rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities.

We do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124. The U.S. Supreme Court stated that the long-established congressional intent of § 3124 is to prevent state taxes which diminish in the *slightest degree* the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. See *Smith v. Davis, supra.* Also, because § 742

was recodified without substantive change, § 3124 still exempts from state taxation those federal obligations, and interest thereon, which are directly and *indirectly* considered in computation of the tax. Furthermore, the Court has interpreted this exemption as "broad" and "sweeping." *See, American Bank & Trust Co. v. Dallas County, supra; Memphis Bank & Trust Co. v. Garner, supra.* Thus, the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the market for federal securities. A review of the expert testimony of Sternlight makes it clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt.

We conclude that the rationale and decision in Revenue Ruling 22-85-1 are invalid and that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124. We thus affirm the district court's judgment with respect to Revenue Ruling 22-85-1.

AFFIRMED.

HASTINGS, C.J., not participating.

CAPORALE, J., dissenting.

I dissent; for when stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

Loewenstein is an investor in funds operated by Massachusetts Business Trusts, a regulated investment company as defined in the Internal Revenue Code, I.R.C. § 851(a) (1988), which funds are commonly known as mutual funds. Under the "General Repurchase Agreement" which controls the transactions in question, a seller of governmental securities to the trusts is obligated to repurchase them by a fixed date, and the trusts are obligated to resell them at a fixed price. In exchange, the trusts receive a fixed rate of return which bears no relationship either to the value of the securities which make up the trusts' funds or to the income the securities produce for the seller, or more accurately, the seller-repurchaser. In short, the seller-repurchaser bears the entire market risk. Moreover, until the repurchase date, the seller-repurchaser has the right to substitute one governmental security for another. Further, the seller-repurchaser and the trusts each have remedies against the other in the event of a default in the respective obligations of either.

Nine of the 10 other appellate courts which have considered this issue have held that under such circumstances, the income to the investors is subject to state taxation: *Hammond Lead Products v. Tax Com'rs*, 575 N.E.2d 998 (Ind. 1991); *Everett v. Dept. of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192 (1990); *Borg v. Dept. of Rev.*, 308 Or. 34, 774 P.2d 1099 (1989); *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. App. 1989); *Massman Const. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *Capital Preservation v. Rev. Dept.*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. App. 1988); *In re Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (1987); *Andras v. Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439 (1987), *cert. denied* 485 U.S. 960, 108 S. Ct. 1223, 99 L. Ed. 2d 424 (1988). The only decision other than that of the majority holding to the contrary is that of an intermediate court of appeals in *Matz v Dep't of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (1986). However, the *Matz* court was construing a state statute defining ownership.

While the fact that nine other courts have reached a contrary result to that reached by the majority is not, in and of itself, particularly persuasive, the reasoning illustrated by *Andras v. Department of Revenue*, 154 Ill. App. 3d at 43-44, 506 N.E.2d at 443-44, is:

> In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations (26 U.S.C. sec 103(a) (1982)) is available only to the taxpayer who actually owns the securities – *i.e.*, the taxpayer who has the right to dispose of them and who

bears the risk of a profit or loss. (See *American National Bank v. United States* (5th Cir. 1970), 421 F.2d 442, 451 (and cases cited therein).) Plaintiffs have cited no authority holding that section 742 requires immunizing from State taxation the income of anyone other than the owner of Federal government securities, nor have we found any authority supporting plaintiffs' position.

While we recognize that section 742 is a constitutionally mandated immunization from taxation (see, *e.g., Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 74 L. Ed. 2d 562, 567, 103 S. Ct. 692, 695-96) rather than a legislative exemption from a particular tax, the scope of the immunity it affords is not unlimited. In *First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. 583, 84 L. Ed. 2d 535, 105 S. Ct. 1516, the Supreme Court held that section 742 did not require a State to permit a bank to deduct the full value of its government securities from its gross assets. The court recognized that, because the bank may have incurred liabilities, the interest on which was also deductible, to acquire the securities, the statute was satisfied by the State's allowing only a *pro rata* deduction from the bank's net worth for the securities. The court concluded that the bank should not be allowed to use Federal obligations to shelter otherwise taxable assets. (470 U.S. 583, 593, 84 L. Ed. 2d 535, 545, 105 S. Ct. 1516, 1523-24.) If the Trust is not the true owner of these securities, but is merely loaning the sellers the securities' purchase price and thereby earning otherwise taxable interest income, we conclude that it may not shelter that income from State taxation by allowing the borrowers to

secure the loans with tax-exempt Federal securities.

In determining whether or not a repurchase transaction is actually a loan, Federal courts consider the entire transaction and look to the following specific factors, which, if present, tend to indicate that the transaction is a loan: (1) whether the seller could require the purchaser to resell the securities; (2) whether the purchaser could require the seller to repurchase them; (3) whether the agreement provides either party a specific remedy in the event that the other defaults; (4) whether the seller agreed to pay interest at a stipulated rate between the sale and resale; and (5) whether the amount advanced does not necessarily equal the fair market value of the securities sold. (See *Citizens National Bank v. United States* (Ct. Cl. 1977), 551 F.2d 832, 842.) Other indications of a loan are: (6) whether the identical securities are bought and sold, and (7) whether the purchaser may sell the securities for the seller's account in the event of a default. See I.R.S. Rev. Rul. 74-27, 1974-1 C.B. 24. See also I.R.S. Rev. Rul. 82-144, 1982-2 C.B. 34 (transaction held to be purchase where the purchaser could sell the securities at will); I.R.S. Rev. Rul. 77-59, 1977-1 C.B. 196 (transaction was found to be loan only and the purchaser's assets were found not to be the securities themselves, but the seller's obligation to repay the funds loaned).

Loewenstein argues that repurchase agreements are essential in order to allow the Federal Reserve to adjust the nation's money supply and points to 12 C.F.R. § 32.103(a) (1993), which provides that U.S. Treasury notes subject to a repurchase agreement do not constitute

a loan or the extension of credit. However, as noted in *Hammond Lead Products v. Tax Com'rs, supra,* that regulation relates to commercial banks and the general scheme of lending limits; it has no bearing on the Internal Revenue Code or the judicial interpretation of repurchase agreements.

Loewenstein also argues that repurchase agreements are necessary to increase the liquidity of mutual funds dealing in government obligations in order to satisfy those investors who wish to avoid inflexible terms in their investments. But government securities are, in and of themselves, very liquid; they can be sold readily, albeit with some short-term market risk. Also, a mutual fund could achieve even greater liquidity by borrowing against the government securities it holds. And a fund could also enhance its liquidity by diversifying the maturity dates of the government securities it acquires. The point is that there are other means to achieve liquidity without the use of repurchase agreements, which take exposure to market risks and other incidents of ownership away from the investor and give them to the seller-repurchaser.

As stated in *Everett v. Dept. of Revenue and Finance,* 470 N.W.2d 13, 15 (Iowa 1991):

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. *Borg,* 308 Or. at 38-39, 774 P.2d at 1102; *In re Thomas Sawyer Estate,* 546 A.2d at 786. We hold that neither the supremacy clause nor 31 U.S.C. section 3124(a) prevents the State from taxing the income derived from the repurchase agreements.

Accordingly, I would reverse the judgment of the district court and remand the cause with the direction that the district court declare Revenue Ruling 22-85-1 to be valid.

GRANT, J., Retired, joins in this dissent.

APPENDIX B

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	Docket 428 Page 177 FINDINGS OF FACT AND CONCLUSIONS OF LAW (Filed Nov. 19, 1990)

This matter came on for trial upon stipulated facts before the undersigned on Monday, July 23, 1990. *Exhibits 1, 2, and 3,* and the attachments thereto, were received by the Court without objection. The parties were directed to submit post-trial briefs, which they have done. The court, being fully advised in the premises, finds as follows:

FINDINGS OF FACT

1. The Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury obligations (the "Trusts") are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.

2. The Trusts do not engage in any other business.

3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M

and are established under the Investment Company Act of 1940.

4. The Trusts are what is commonly known as "mutual funds."

5. The Trusts make U.S. Government securities accessible to investors in much smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

7. The Trusts hold U. S. Government securities and Treasury obligations directly and through repurchase agreements.

8. Each of the federal securities held by the Trusts, either directly or through repurchase agreements, are "obligations of the United States . . . exempt from state income taxes under the laws of the United States" as that term is used in NEB. REV. STAT. § 77-2716 (1988 Cum. Supp.).

9. A typical repurchase agreement used by the Trusts was attached as *Exhibit A* to *Exhibit 2.*

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

16. For example, in the case of a two percent differential, the buyer will receive $1,020,000 of securities for the purchase price of $1,000,000.

17. The differential provides a margin of financial security for the buyer in case the securities decline in value and the seller fails to repurchase them.

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

20. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the Trusts, after deducting the administrative costs associated with the U.S. obligations.

21. The Trusts have historically distributed all of their net income to their shareholders.

22. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4, a copy of which was attached as *Exhibit B* to *Exhibit 2*.

23. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80 percent or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

24. The defendant has advised taxpayers through the instructions included with the Nebraska Individual Income Tax forms for 1987 and subsequent years that repurchase agreements covering U.S. Government securities cannot be counted towards satisfying the 80 percent requirement of this Revenue Ruling.

25. At the end of each quarter of the tax year in 1987 less than 80 percent of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

26. As a result of the foregoing Revenue Ruling, defendant maintains that plaintiff's dividends for 1987 and subsequent years received from the Trusts are subject to the Nebraska state income tax.

CONCLUSIONS OF LAW

1. This is an action for declaratory relief pursuant to NEB. REV. STAT. § 84-911 (1987).

2. The court has jurisdiction over the action and the parties.

3. The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities market.

4. If the State of Nebraska were allowed to impose a tax on income from government obligations that are the subject of a repurchase agreement, it would impair the repurchase market and add to Treasury interest costs.

5. A Nebraska taxpayer is subject to a state income tax on his or her federal adjusted gross income under NEB. REV. STAT. § 77-2715(2) (1988), as modified by § 77-2716.

6. NEB. REV. STAT. § 77-2716(1)(a) exempts from Nebraska income tax "interest or dividends received by the owner of obligations of the United States . . . exempt from state income taxes under the laws of the United States."

7. Rev. Rul. 22-87-4 purports to limit the availability of this exemption to obligations "directly owned."

8. Title 31, U.S.C. § 3124(a), provides that:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

9. That provision represents a codification of prior law which was enacted in 1959 as Section 3701 of the Revised Statutes, 31 U.S.C. § 742. In addition to the language set forth above, the law in 1959 included the following language:

> This exemption [from state taxes] extends to every form of taxation that would require that either the [federal] obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. . . .

Pub. L. 86-346, 105(a), 73 Stat. 622 (1959).

In 1982, when Congress recodified this provision as 31 U.S.C. § 3124(a), the words "directly or indirectly" were "omitted as surplus." H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982). The changes in language prompted by the recodification were not intended to make any "substantive change" in existing law. See *Id.* at 1-3. Therefore, although 31 U.S.C. § 3124(a) does not include the phrase "directly or indirectly," the statutory prohibition still extends to state taxes that indirectly, as well as directly, require the consideration of interest earned on, or the value of, federal obligations in their computations.

The limitation contained in Revenue Ruling 22-87-4 purporting to limit the exemption of taxation of interest from federal obligations to obligations "directly owned" violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

10. The imposition of the Nebraska income tax on distributions from the Trusts to the Plaintiff reflecting his proportionate share of interest on federal obligations which are the subject of repurchase agreements would violate 31 U.S.C. § 3124(a) and the Supremacy Clause of the U. S. Constitution.

11. Revenue Ruling 22-87-4 is also invalid because it allows for an imposition of the Nebraska state income tax on one hundred percent of the distribution from a regulated investment company unless "for every quarter of the taxable year, 80% or more of the assets of a regulated investment company are directly owned United States government obligations." As a result, the Revenue Ruling allows for the imposition of the Nebraska state income tax on distributions representing the Plaintiff's proportionate share of interest on directly owned United States government obligations if they are part of a fund which cannot meet the 80% test.

12. The imposition of the Nebraska state income tax on any interest derived from United States obligations, regardless of the relative amount involved, is a violation of 31 U.S.C. § 3124 (a) and the Supremacy Clause of the United States Constitution.

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Ruling 22-87-4 is void and of no effect. Costs are taxed to the Defendant.

DATED this 19th day of November, 1990.

BY THE COURT:

/s/ Donald E. Endacott
Donald E. Endacott,
District Judge

APPENDIX C

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 ORDER AMENDING "FINDINGS OF FACT AND CONCLUSIONS OF LAW" AND OVERRULING DEFENDANT'S MOTION FOR NEW TRIAL (Filed Feb. 14, 1991)

This matter came before the court upon the parties' "Joint Motion Amending Pleadings to Conform to the Proof" and upon the defendant's Motion for New Trial. The court has sustained the Joint Motion. Accordingly, the court's "Findings of Fact and Conclusions of Law" are amended by adding the following finding of fact:

22A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a

taxpayer's federal taxable income on the Nebraska return.

The court's findings are further amended by adding the following conclusions of law:

7A. Rev. Rul. 22-85-1 purports to limit the availability of this exemption to obligations which are not the subject of repurchase agreements.

9A. The limitation contained in Revenue Ruling 22-85-1 purporting to limit the exemption of taxation of interest from federal obligations to obligations which are not the subject of repurchase agreements violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

Finally, the last paragraph of the court's Order of November 19, 1990 is amended to read as follows:

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Rulings 22-85-1 and 22-87-4 are void and of no effect. Costs are taxed to the defendant.

Defendant's Motion for New Trial is denied.

DATED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald E. Endacott
Donald Endacott
District Court Judge

PREPARED BY:

CLINE, WILLIAMS, WRIGHT,
JOHNSON & OLDFATHER
1900 FirsTier Bank Bldg.
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By /s/ Terry R. Wittler
Terry R. Wittler, #15584

APPROVED AS TO FORM ONLY:

DONALD STENBERG,
Attorney General

By /s/ David E. Cygan
David Edward Cygan, #18546
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APPENDIX D

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177)))))))	PETITION FOR DECLARATORY JUDGMENT (Filed May 6, 1988)

COMES NOW the plaintiff and for his cause of action alleges as follows:

1. Plaintiff is a citizen of the State of Nebraska and a resident of Lincoln, Lancaster County, Nebraska.

2. Defendant, Department of Revenue, is the duly created agency and instrumentality of the State of Nebraska charged with the administration and collection of the Nebraska income tax.

3. This is an action for declaratory relief pursuant to Neb. Rev. Stat. ~~§ 25-21, 149 (1985 et seq.).~~ 84-911 (1987) challenging the validity of an agency rule. [/s/ TRW 7/1/88]

4. On the 31st day of December, 1986, the plaintiff owned 1,178.64 shares of the Trust for Short-Term U.S. Government Securities at a price per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout 1987.

5. On July 14, 1987, plaintiff purchased 4,444.41 shares of the Trust for U.S. Treasury Obligations at a price

per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout the remainder of 1987. On the 31st day of December, 1987, the plaintiff owned 17,513.86 shares of this trust.

6. The Trusts are no-load, open-end, diversified investment companies whose primary objective is to receive current income from their investment in U.S. Government securities and obligations. They do not engage in any other business.

7. The Trusts, which are principally located in Pittsburgh, Pennsylvania, are organized as Massachusetts Business Trusts, are qualified as regulated investment companies under Internal Revenue Code Subchapter M, and are established under the Investment Company Act of 1940. They are what is commonly known as "mutual funds."

8. The Trusts make it possible for investors to purchase U.S. Government securities in much smaller denominations than sold in the marketplace, and provide a distribution of the risk through a diversified portfolio. There is no minimum purchase requirement for investors who purchase through a fiduciary, such as a bank trust department.

9. The Trusts invest exclusively in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities. Each of the federal securities held by the Trusts, if owned directly by the Trusts' shareholders, would be exempt from Nebraska income tax.

10. The Trusts invest in U.S. Government securities and Treasury Obligations directly and through repurchase agreements. The Trusts' repurchase agreement provides in Paragraph 18 that the intent of the parties is that the transaction be considered as a sale. Actual delivery is taken of the securities through the Federal Reserve book entry system. There is no promissory note executed in connection with the repurchase agreement, nor is there any indebtedness on behalf of the Trusts to the seller of the federal securities under the repurchase agreement. The sales price of the securities is the market value on the date of the repurchase agreement.

11. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the trusts, after deducting the administrative costs associated with the U.S. obligations. The Trusts have historically distributed all of their net income to their shareholders.

12. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80% or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

13. The defendant has advised taxpayers through the instructions included with the 1987 Nebraska Individual Income Tax forms that repurchase agreements covering U.S. Government securities cannot be counted

towards satisfying the 80% requirement of this Revenue Ruling.

14. In calendar year 1987, Plaintiff received dividends of $129.29, reflecting his share of the income of the Trust for Short-Term U.S. Government Securities and $734.61 reflecting his share of the income of the Trust for Treasurer Obligations.

15. In 1987, less than 80% of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

16. As a result of the foregoing Revenue Ruling, defendant intends to impose the Nebraska state income tax on plaintiff's dividends for 1987 received from the Trusts. In addition, plaintiff believes that defendant intends to impose such a tax on any such dividends received by the plaintiff in 1988 and in future years.

17. Any imposition of an income tax by defendant upon the dividends received by plaintiff from the Trusts violates 31 U.S.C. § 3124(a) and the supremacy clause of the U.S. Constitution.

18. Plaintiff does not have an adequate remedy at law.

WHEREFORE, plaintiff prays that the court determine that Revenue Ruling 22-87-4 violates 31 U.S.C. § 3124, Neb. Rev. Stat. § 77-2716 (1987), and the supremacy clause of the U.S. Constitution and further declaring that dividends received by the plaintiff from the Trusts

are not includable within plaintiff's income for purposes of the Nebraska income tax.

JOHN LOEWENSTEIN, Plaintiff

By: CLINE, WILLIAMS, WRIGHT, JOHNSON & OLDFATHER
1900 FirsTier Bank Bldg.
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(402) 474-6900

By: /s/ Terry R. Wittler
Larry A. Holle #11889 and
Terry R. Wittler #15584

APPENDIX E

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 ANSWER (Filed July 11, 1988)

Defendant State of Nebraska Department of Revenue, for answer to the petition filed herein, admits, denies, and alleges as follows:

1. Admits the allegations in paragraphs 1, 2, 3, 12, and 13.

2. For lack of knowledge, defendant denies the allegations of paragraphs 4, 5, 6, 7, 8, 9, 10, 11, 14, and 15.

3. Admits the allegation of paragraph 16, provided the dividends referred to therein fall within the purview of Revenue Ruling 22-87-4.

4. Denies the allegations of paragraphs 17 and 18.

5. Alleges the imposition of Nebraska income tax on dividends received by plaintiff from the Trusts in question does not violate 31 U.S.C. § 3124, Neb.Rev.Stat. § 77-2716 (Supp. 1987), or the Supremacy Clause of the U. S. Constitution.

WHEREFORE, defendant prays that the court determine that Revenue Ruling 22-87-4 is valid and constitutional in all respects, and does not exceed the statutory authority of the agency. Defendant further prays that the court dismiss plaintiff's petition, at plaintiff's cost.

STATE OF NEBRASKA DEPARTMENT
OF REVENUE, Defendant,

BY ROBERT M. SPIRE, #13977
Attorney General

BY /s/ L. Jay Bartel
L. Jay Bartel, #17247
Assistant Attorney General
2115 State Capitol
Lincoln, NE 68509-4906
Tel: (402) 471-2682

ATTORNEYS FOR DEFENDANT.

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing Answer upon the plaintiff herein by placing a copy of the same in the United States Mail, first class postage prepaid, addressed to plaintiff's attorneys of record, Larry A. Holle and Terry R. Wittler, Cline, Williams, Wright, Johnson & Oldfather, 1900 FirsTier Bank Bldg., Lincoln, NE 68508, on this 11th day of July, 1988.

/s/ L. Jay Bartel
L. Jay Bartel
Assistant Attorney General

APPENDIX F

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177)) JOINT MOTION AND ORDER AMENDING PLEADINGS TO CONFORM TO THE PROOF)) (Filed Feb. 14, 1991)

The parties jointly move the court for an order pursuant to Neb. Rev. Stat. § 25-852 (1989) conforming the pleadings to the issues actually tried by allowing an amendment instanter by rider to the plaintiff's Petition as follows:

12A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

The parties further stipulate that the prayer of the plaintiff's Petition be amended to include a request that Revenue Ruling 22-85-1 also be declared invalid.

JOHN LOEWENSTEIN, plaintiff

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By /s/ Terry R. Wittler
Terry R. Wittler, #15584

STATE OF NEBRASKA DEPARTMENT OF REVENUE, defendant

By DONALD STENBERG,
Attorney General

By /s/ David E. Cygan
David Edward Cygan, #18546
Assistant Attorney General
2115 State Capitol
Lincoln, Nebraska 68509-4906

ORDER

IT IS SO ORDERED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald Endacott
Donald Endacott
District Court Judge